

DOCKET SECTION

RECEIVED AMMA-T-2

DEC 30 11 34 AM '97

POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001**

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

Direct Testimony
of
GARY M. ANDREW
Senior Consultant
L. E. Peabody & Associates, Inc.

On Behalf Of
ADVERTISING MAIL MARKETING ASSOCIATION

Communications with respect to this document may be sent to:

Ian D. Volner, Esquire
N. Frank Wiggins, Esquire
Venable, Baetjer, Howard & Civiletti, L.L.P.
Suite 1000
Washington, D.C. 20005

Due Date: December 30, 1997

<u>TABLE OF CONTENTS</u>	<u>PAGE</u>
I. INTRODUCTION	1
II. PURPOSE OF THE TESTIMONY	3
III. SUMMARY AND FINDINGS	4
IV. DESTINATION ENTRY DISCOUNTS IN MC95-1	6
V. PROPOSED DESTINATION ENTRY DISCOUNTS WILL NOT "MAXIMIZE PRODUCTIVE EFFICIENCY"	8
VI. RESTATEMENT OF DESTINATION ENTRY DISCOUNTS	11
VII. IMPACT OF 100% PASSTHROUGH ON BASE RATES	12

LIST OF EXHIBITS

ITEM
(1)

TITLE
(2)

Appendix A

Statement of Qualifications

**DIRECT TESTIMONY
OF
GARY M. ANDREW**

I. INTRODUCTION

1 My name is Gary M. Andrew. I am Senior Consultant with the firm of L. E. Peabody &
2 Associates, Inc. The firm's offices are located at 1501 Duke Street, Suite 200, Alexandria,
3 Virginia 22314. I have, on numerous prior occasions, presented evidence before the Interstate
4 Commerce Commission (now the Surface Transportation Board) and state agencies on the
5 subjects of measurement and optimization of economic systems. I presented evidence before the
6 Postal Rate Commission ("PRC") in Docket No. R90-1, Postal Rate and Fee Changes, 1990
7 ("R90-1") related to the proper measurement of the United States Postal Service's ("USPS")
8 attributable costs. In PRC Docket No. R94-1, Postal Rate and Fee Changes, 1994, I submitted
9 evidence on rate design and its impact on third class bulk mailers. My qualifications and
10 experience are detailed in Appendix A to this statement.

11 I have been requested by the Advertising Mail Marketing Association ("AMMA") to review
12 the testimony of USPS' witnesses related to the proposed discounts applicable to Standard (A)
13 mail entering the mail flow at the Bulk Mail Center ("BMC"), Sectional Center Facility ("SCF")
14 and Destination Delivery Unit ("DDU"). Witness Moeller states that the "passthrough of
15 80 percent generally maintains the discounts at current levels and continues to encourage mailer
16 dropshipment".^{1/}

^{1/} USPS-T-36 page 20. This passage refers to Standard Mail (A) Regular Subclass. At page 30, Witness Moeller makes the same statement regarding Standard Mail (A) Enhanced Carrier Route Subclass ("ECR") mail.

1 The balance of my testimony is organized under the following topical headings:

2 II. Purpose of the Testimony

3 III. Summary and Findings

4 IV. Destination Entry Discounts in MC95-1

5 V. Proposed Destination Entry Discounts Will Not "Maximize Productive Efficiency"

6 VI. Restatement of Destination Entry Discounts

7 VII. Impact of 100% Passthrough on Base Rates

1 **II. PURPOSE OF THE TESTIMONY**

2 AMMA asked me to examine the USPS' Proposed destination entry discounts and all data,
3 analysis and assumptions used by USPS witnesses in the development of the destination entry
4 discounts. Furthermore, I was asked to examine the development of destination entry discounts
5 in PRC Docket No. MC95-1, ("MC95-1"). Finally, I was asked to restate the destination entry
6 discounts based on the proper passthrough percentage and to evaluate the impact of the restated
7 discounts on the base rates of Standard (A) Commercial mail. The purpose of my testimony is
8 to present the results of this research and to propose destination entry discounts based on 100%
9 passthrough of cost savings consistent with the PRC's decision in MC95-1.^{2/}

^{2/} PRC's Opinion and Recommended Decision in Docket No. MC95-1 dated January 26, 1996 ("MC95-1 Decision")

III. SUMMARY AND FINDINGS

Based on a thorough review of the testimony submitted by USPS' Witness Moeller and prior PRC decisions, I conclude that the passthrough of 80 percent of the cost savings for destination entry discounts should be increased to 100 percent. The results of my analyses are summarized below:

1. The cost savings presented in this proceeding for mail entered at the BMC, SCF and DDU are between 25 percent and 41 percent greater than the cost savings developed by the PRC in MC95-1;
2. Witness Moeller has proposed destination entry discounts equal to 80 percent of the cost savings for destination entry;
3. Witness Moeller's proposal reduces the differential in the destination entry discount between BMC and SCF by 0.2 cents per piece and 0.5 cents per pound from MC95-1 levels. Witness Moeller's proposal also reduces the differential in destination entry discount between SCF and DDU by 0.4 cents per pound from MC95-1 levels;
4. In MC95-1, the PRC increased destination entry discounts from 95 percent passthrough of the cost saving to 100 percent to "maximize productive efficiency within postal markets";
5. When 100 percent of the cost savings are passed through for the destination entry discounts in this proceeding, the discounts are as shown in Table 1 below:

Table 1
Summary of Destination Entry Discounts
Based on 100 Percent Passthrough of Cost Savings

<u>Item</u> (1)	<u>Discount (cents)</u>	
	<u>Per Piece</u> (2)	<u>Per Pound</u> (3)
1. BMC	1.9¢	9.0¢
2. SCF	2.3	11.0
3. DDU	2.8	13.8

6. Based on the destination entry discounts proposed in Table 1 above, the differential in the discounts between BMC and SCF as well as between SCF and DDU will remain at approximately the same levels as the current (MC95-1) rate levels, as summarized in Table 2 below:

Table 2
Comparison of Difference Between
Current and Proposed Destination Entry Discounts

<u>Item</u> (1)	<u>Difference (cents per piece)</u>	
	<u>Current (MC95-1)</u> (2)	<u>Proposed (100% Passthrough)</u> (3)
<u>Per Piece</u>		
1. BMC and SCF	0.5¢	0.4¢
2. SCF and DDU	0.5	0.5
<u>Per Pound</u>		
3. BMC and SCF	2.1¢	2.0¢
4. SCF and DDU	2.6	2.8

The basis for each of my conclusions is discussed below.

1 **IV. DESTINATION ENTRY DISCOUNTS IN MC95-1**

2 In MC95-1 Witness Moeller presented the USPS' proposed destination entry discounts.
3 In his proposal, only 95 percent of the cost savings in Standard Mail (A) Regular Subclass were
4 passed through to the discount (MC95-1 Decision, page V-152). This proposal was evaluated
5 by the PRC and rejected in favor of a 100 percent passthrough of the cost savings. Furthermore
6 Witness Moeller proposed 100% of the cost savings in Standard Mail (A) ECR subclass be
7 passed through to the discount (MC95-1 Decision page V-154). This proposal was accepted by
8 the PRC. The PRC based it's conclusion on the following:

9 In this docket the Postal Service proposes a new approach to calculating cost
10 differentials underlying workshare discounts; specifically, one that measures *all* cost
11 differences. The Commission concludes that cost differentials should reflect costs
12 avoided by required worksharing alone, since the primary purpose of the discount is to
13 maximize productive efficiency within postal markets. Accordingly, the Commission
14 makes limited adjustments to the Postal Service's estimates of full cost differences in
15 order to be more consistent with estimates of costs avoided by required worksharing.
16 (MC95-1 Decision, page IV-95)

17 The PRC went on to state:

18 This record has reconfirmed the Commission's long-held view that workshare
19 discounts should reflect the costs that the Postal Service avoids by worksharing, so that
20 the category makes the same per-piece contribution to institutional costs that it would
21 have made had it not undergone worksharing. (MC95-1 Decision, page IV-96).

22 The destination entry discount (and cost savings) per piece and per pound as determined in
23 MC95-1 are summarized in Table 3 below:

Table 3
Summary of Discounts and Cost Savings
For Destination Entry — MC95-1

Item (1)	Cents	
	Per Piece (2)	Per Pound (3)
1. Discount and Cost Savings		
a. BMC's	1.3¢	6.4¢
b. SCF	1.8	8.5
c. DDU	2.3	11.1
2. Difference Between		
a. BMC and SCF (Line 1b - Line 1a)	0.5	2.1
b. SCF and DDU (Line 1c - Line 1b)	0.5	2.6

Source: MC95-1 Decision, Table V-6, page V-266

In MC95-1, the destination entry discount equalled the cost savings (i.e., 100 percent passthrough). The discount per piece ranged between 1.3 cents per piece and 2.3 cents per piece. The discount per pound ranged between 6.4 cents per pound and 11.1 cents per pound. The differential between the discounts for BMC and SCF equalled 0.5 cents per piece and 2.1 cents per pound. The differential between SCF and DDU equalled 0.5 cents per piece and 2.6 cents per pound.

**V. PROPOSED DESTINATION ENTRY DISCOUNTS
WILL NOT "MAXIMIZE PRODUCTIVE EFFICIENCY"**

As discussed above, Witness Moeller utilized the cost savings developed by the USPS related to destination entry dropshipping and proposed discounts based on 80 percent of the cost savings, i.e., 80% passthrough.^{3/} Table 4 below identifies the cost savings and discounts in Witness Moeller's analysis:

Table 4 Summary of Cost Savings and Destination Entry Discounts in Witness Moeller's Analysis			
Item (1)	Cents		Per Pound (3)
	Per Piece (2)		
1. Cost Savings ^{1/}			
a. BMC	1.86¢		9.04¢
b. SCF	2.28		11.04
c. DDU	2.84		13.78
2. Destination Entry Discounts ^{2/} (line 1 x 80%)			
a. BMC	1.5		7.2
b. SCF	1.8		8.8
c. DDU	2.3		11.0
3. Difference in Discount between			
a. BMC and SCF (Line 2b - Line 2a)	0.3		1.6
b. SCF and DDU (Line 2c - Line 2b)	0.5		2.2
^{1/} LR-H-111, page 2 revised November 20, 1997.			
^{2/} USPS-T-36, WP1, pages 30 and 31. The piece rate discount equals the per pound rate in Column (3) times the weight at the breakout 3.3 ounces divided by 16 ounces per pound.			

^{3/} The cost savings per pound were developed in LR-H-111.

1 The discount per piece in Witness Moeller's proposal ranges between 1.5 cents per piece
2 and 2.3 cents per piece. The discount per pound in Witness Moeller's proposal ranges between
3 7.2 cents per pound and 11.0 cents per pound. The differential between the discounts for BMC
4 and SCF equals 0.3 cents per piece and 1.6 cents per pound. The differential between SCF and
5 DDU equals 0.5 cents per piece and 2.2 cents per pound.

6 Witness Moeller has not followed the PRC's logic and conclusions of the MC95-1 Decision.
7 Specifically, he should have utilized a 100 percent passthrough. Under Witness Moeller's
8 proposal, mail that is dropshipped will have a greater contribution to institutional costs than mail
9 that is not dropshipped.^{4/} The 20 percent of the cost savings that is not passed through to the
10 mailer will be a contribution to institutional costs in addition to the mark up on the entire cost
11 savings.

12 The 80 percent passthroughs proposed by the USPS fail to meet the objective of worksharing
13 discounts to "maximize productive efficiency within postal markets".^{5/} This failure can be
14 demonstrated by using the savings and discounts stated in Table 4, above.

15 The destination entry discount offered by Witness Moeller at the BMC is 1.5 cents per piece
16 and the cost savings to the Postal Service is 1.86 cents per piece. Any mailing that a mailer can
17 transport to the destination BMC for less than 1.5 cents per piece will be dropshipped, and any

^{4/} Furthermore, the increase in contribution for BMC, SCF and DDU mail will not be the same. For example, the BMC discount mail contributes 1.8 cent per pound to institutional costs (9.0 cents in cost savings less 7.2 cents per pound discount) while the DDU discount contributes 2.8 cents per pound (13.8 cents per pound cost savings less 11.0 cent per pound discount).

^{5/} MC95-1 Decision, page IV-95.

1 mailing costing 1.5 cent per piece or more will not.^{6/} Any mailing with a dropship cost to the
2 mailer more than 1.5 cents per piece and less than 1.86 cents per piece will be carried to the
3 destination BMC by the USPS when a more efficient alternative exists. This is a false price
4 signal to the market; i.e., the signal says the marginal cost of this service is 1.5 cents per piece
5 when it is actually 1.86 cents per piece. The result of less than 100 percent passthrough of
6 worksharing costs savings is a failure to meet the object to "maximize productive efficiency".

^{6/} Witness Schick (AMMA-T-1 page 4) states that many mailers have computer programs that make this decision for each mailing.

VI. RESTATEMENT OF DESTINATION ENTRY DISCOUNTS

Based on the analysis discussed above and the guidelines in the MC95-1 Decision, I have restated the destination entry discounts to reflect a 100 percent passthrough of the cost savings. My restatement is shown in Table 5 below:

Table 5 Summary of Proposed Discounts For Destination Entry Based on 100 Percent Passthrough		
Item (1)	Cents	
	Per Piece (2)	Per Pound (3)
1. Destination Entry Discount ^{1/}		
a. BMC	1.9	9.0
b. SCF	2.3	11.0
c. DDU	2.8	13.8
2. Difference in Discount between		
a. BMC and SCF		
(Line 1b - Line 1a)	0.4	2.0
b. SCF and DDU		
(Line 1c - Line 1b)	0.5	2.8
^{1/} Table 4, Line 1, rounded to nearest mill.		

The proposed discount per piece ranges between 1.9 cents per piece and 2.8 cents per piece. The proposed discount per pound ranges between 9.0 cents per pound and 13.8 cents per pound. The differential between the discounts for BMC and SCF equals 0.4 cents per piece and 2.0 cents per pound. The differential between SCF and DDU equals 0.5 cents per piece and 2.8 cents per pound.

VII. IMPACT OF 100% PASSTHROUGH ON BASE RATES

The change in dropship discounts to reflect 100 percent passthrough will have a small impact on base rates. I have used Witness Moeller's rate formula^{2/} for determining base rates and set the passthroughs at 100 percent for destination entry cost savings. Table 6 shows a comparison of Witness Moellers' base rates (USPS Proposed) and the base rates with 100 percent passthrough (AMMA Proposed).

Table 6
Changes in Standard (A) Commercial Mail Base Rates
Resulting From 100% Passthrough Of Dropship Savings

<u>Subclass</u> (1)	<u>Basic Piece Rate (cents/piece)</u>		
	<u>USPS</u> <u>Proposed^{1/}</u> (2)	<u>AMMA</u> <u>Proposed^{2/}</u> (3)	<u>Change</u> (4)
<u>Regular</u>			
1. Piece Rated Pieces	30.0¢	30.2¢	+0.2¢
2. Pound Rated Pieces ^{3/}	16.6	16.8	+0.2
<u>ECR</u>			
1. Piece Rated Pieces	16.4	16.9	+0.5
2. Pound Rated Pieces ^{3/}	5.5	6.0	+0.5

^{1/} USPS-T-36 WP1 pages 30 and 31.

^{2/} USPS-T-36 WP1 pages 30 and 31 after discount passthroughs on page 9 (DROP), Column (4) have all been set equal to 100%.

^{3/} The pound rate per pound proposed by Witness Moeller does not change.

^{2/} USPS-T-36-WP1 page 9.

1 The base rate for Standard Mail (A) Commercial Regular subclass increases by 0.2 cents
2 per piece. The base rate for Standard Mail (A) Commercial ECR subclass increase 0.5 cents
3 per piece. There is no change in the pound rate.

**STATEMENT
OF
QUALIFICATIONS**

My name is Gary M. Andrew. I am a Senior Consultant with the economic consulting firm of L.E. Peabody & Associates, Inc. The firm's offices are located at 1501 Duke Street, Suite 200, Alexandria, Virginia 22314.

I received a Bachelor of Arts degree in Mathematics from DePauw University in 1961, the Bachelor of Science in Management Science from Case Institute of Technology in 1961, and the Doctor of Philosophy degree from Case Institute of Technology in 1966. My major field of study was operations research, with a minor in statistics. I also completed every advanced course in statistics and econometrics at Case Institute of Technology offered between 1961 and 1964.

At Case Institute of Technology, I taught courses in statistics, sampling and operations research, and worked in the Case Operations Research Group and the Case Statistical Laboratory on research projects in theoretical and applied statistics, including transportation problems. I was a member of a research team that developed one of the first digital computer simulations of railroad operations for a division of the C&O Railroad.

From 1964 to 1971, I taught courses and advised students and persons in business in theoretical and applied statistics, sampling, and operations research in the School of Business Administration and the Department of Statistics at the University of Minnesota, Minneapolis,

Minnesota. During this period, I consulted with several railroads, truckers, airlines, and shippers and presented testimony before the Interstate Commerce Commission in numerous rate, abandonment and merger cases. I have also published articles and consulted on work sampling procedures. My consultations have included pricing decisions for several firms.

In 1971, I became Director of Planning and Analysis at the University of Colorado and, in June 1974, I was promoted to Vice Chancellor for Administration in charge of all support activities on the Boulder Campus. My responsibilities included estimation, justification, and cost control for over \$50 million in construction for the University during my tenure. I also had responsibility for both the United States Postal Service installation on the Boulder campus and the private mail system for the four campuses. I was on the Graduate Faculty of the School of Business and continued my consulting practice in statistical sampling and estimation procedures in addition to my administrative responsibilities at the University of Colorado.

In September of 1978, I resigned my administrative position at the University of Colorado to devote full time to consulting and other business interests. I formed Infomap, Inc., a computer mapping and software firm specializing in the geographical display of statistical data, developed this company and sold it to Rand McNally and Company in 1983. I worked as Director of Internal Consulting for Rand McNally until 1986.

For 30 years, I have worked with the firm of L.E. Peabody & Associates, Inc. as a consultant on various special projects. In January 1988, I joined the firm as a Senior Consultant. My work with L.E. Peabody & Associates, Inc. has included the development of mathematical models of economic systems, statistical sampling procedures and statistical models

for analyzing the relationship between costs and volumes in large data bases. I have, on numerous occasions, presented testimony in rate proceedings as an expert witness in mathematical modeling. I presented testimony on costing models before the Postal Rate Commission in Docket No. R90-1, Postal Rates and Fee Changes, 1990, and testimony in Docket No. R94-1, Postal Rate and Fee Changes, 1994.

I am a member of the American Statistical Association and the Institute for Operations Research and the Management Sciences. I have published papers on statistics in recognized professional journals, and have won awards for work in economics and statistics including the Carlton Prize in Economics at Case Institute of Technology.

I was a reviewer of and contributor to The Guidelines for the Presentation of the Results of Sample Studies, Statement No. 71-1 (Interstate Commerce Commission, February 1971).